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The Morgan Guaranty Survey

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Economy Watch. *Look for another good year. Fourth quarter to fourth quarter, real GNP should rise about 5%—as against 6% in the previous year. Consumer prices, though up a bit, should climb less than 5%.* 2

Unemployment. *The drop in joblessness has been the sharpest in 30 years. What has caused the decline—and will it continue?* 3

Borrowing Outlook. *Credit growth will exceed 1983's, even though economic expansion slows. But interest rates are likely to show little change from present levels. The credit picture, sector by sector.* 7

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Notice to Readers

The Morgan Guaranty Survey, which was first published in April 1921, will be discontinued with this issue.

Our decision to cease publication reflects the radical transformation which has occurred in recent years in the availability of general economic intelligence. Whereas the *Survey* only a relatively short time ago was one of a handful of publications of its kind, there now exists a multitude of weeklies and monthlies that disseminate economic information and commentary.

The Morgan Bank is planning a new publication *The Morgan Economic Quarterly* that will appear later this year. Each issue will contain an in-depth analysis and forecast of economic and financial trends. Also, as circumstances warrant, there will be articles focusing on economic policy issues and financial-service industry developments. Distribution will be restricted to Morgan clients. Clients interested in receiving the quarterly should make requests in writing to their Morgan banker.

On the occasion of this final issue, we would like to thank the many readers who over the years have communicated their appreciation of the *Survey.*

Milton W. Hudson
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Economy Watch

THE U.S. economy has entered 1984 with strong momentum. While growth has slowed from last year's pace, prospects are bright for continued expansion.

The deceleration in activity reflects developments that are normal in the second year of an economic expansion. Although inventories are still lean, restocking will provide less of a lift in 1984 than it did in 1983. And housing activity is expected to stabilize at the current 1¾ million unit production rate.

Real GNP rose at an estimated 4½% annual rate in the fourth quarter, according to the Commerce Department's widely watched "flash" estimate. That was fully three percentage points under the previous quarter's growth rate, and well below the 6%-to-7% consensus forecast range.

Significantly, the GNP estimate masks divergent trends in the farm and nonfarm sectors. Farm output dropped sharply last year in response to the worst drought of this century and the Administration's efforts to discourage production through the Payment-In-Kind (PIK) subsidy program. That decline appears to have steepened in the fourth quarter—a peak harvest period.

Nonfarm business activity, on the other hand, continues to show considerable zip. The Morgan Bank estimates that in the fourth quarter the output of this sector expanded at an annual rate between 6% and 8%—only moderately less than the third quarter's 8½% rate. This expansion implies an underlying momentum that is clearly more than Fed officials have indicated they would tolerate over any protracted period.

Yet continued strength in nonfarm output seems likely, at least for the next few months. Auto sales perked up in December, and consumers, enjoying steady advances in real income and employment, treated retailers to the best Christmas season in recent memory. Indeed, so brisk was the sales pace at year-end that inventories have apparently risen little. They now seem low enough in relation to sales that businesses are apt to keep stepping up production until they make some progress in replenishing stocks, an outcome supported by the recent impressive surge in factory orders.

All in all, the tempo of the economy—though evidently modulating to a lower key—has solid underpinnings. The Morgan Bank's forecast (table on this page) calls for real GNP to advance about 5% between the fourth quarter of 1983 and the fourth quarter of 1984. Growth at this rate surely will permit further progress in

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983	1984			
	Q4	Q1	Q2	Q3	Q4
Real GNP	4.5	4.8	5.0	5.5	5.0
Real consumer spending	6.3	4.7	3.3	3.4	2.8
Real business-capital outlays	13.8	9.7	8.8	8.8	10.4
GNP deflator	4.0	3.9	4.3	4.7	5.1
Consumer prices	4.8	4.3	4.9	5.2	5.0
Real disposable personal income	6.1	2.8	2.4	3.1	3.5
Saving rate (%)	4.9	4.4	4.2	4.1	4.2
Housing starts (Millions)	1.7	1.7	1.7	1.7	1.7
Auto sales (Millions)	9.9	10.1	10.2	10.4	10.5
Unemployment rate (%)	8.5	8.2	8.0	7.7	7.5

paring unemployment rolls, though the decline in joblessness is not likely to match last year's extraordinary improvement (story below).

With slack in labor and capital resources diminishing, attention is turning quite naturally to price trends. Thus far, the indexes have behaved remarkably well. Last year's slump in world oil prices and an absence of upward pressures on food prices reinforced an exceptionally sharp cyclical deceleration in labor costs to produce the lowest annual inflation numbers in more than a decade.

Even though the best news on inflation probably has passed, price increases in 1984 are likely to be moderate. This year is a big one for collective bargaining, but these negotiations are not likely to result in significantly larger wage settlements (box on page 4). Energy prices, also, are unlikely to cause a problem. Oil demand by industrialized countries other than the U.S. has been held back by the sluggish pace of world economic recovery. And, since oil markets require payment in dollars, the persistent strength in the dollar has boosted the cost of oil for foreign buyers. In the food sector, larger price increases are in store, reflecting the effects both of last year's drought on meat supplies and of the recent freeze on fruit and vegetable prices. The probable net result: a moderate pickup in inflation relative to 1983—to 4.8% in the consumer price index from 3.3% last year.

Despite the slowing in economic expansion, both businesses and households are apt to turn increasingly to credit markets in 1984 to finance their expenditures. That will occur at a time when borrowing by the U.S. Treasury is setting new records (story on page 7). In this environment, and with the Federal Reserve anxious to regulate the pace of economic expansion, it is difficult to foresee any major easing in interest rates this year.

Behind the Decline in Unemployment

ONE of the best pieces of news in the past year has been the dramatic drop in unemployment—a decline that far exceeded all expectations. When 1983 began, unemployment stood at a 40-year high of 10.7% of the civilian labor force. A year later, the rate is only slightly over 8%. The drop of 2½ percentage points during 1983 is the largest 12-month decline since the build up for the Korean War.

A major reason for the decrease in joblessness was, of course, the strong economic recovery. The increase of over 6% in real GNP and 16% in industrial production in the past year created almost 4 million jobs.

Employment growth, however, is only part of the explanation. Indeed, employment grew just as fast in previous recoveries, when unemployment failed to drop as rapidly as it did in the past year. The additional element has been a slowing in the rate of growth of the labor force.

Compared with the late 1970s—also a period of economic recovery—a much higher percentage of this past year's increase in employment went to reduce unemployment rather than to accommodate new entrants into the labor force (table on page 5). Thus, even though employment growth in the two periods was about the same, the unemployment rate in the past year

COLLECTIVE BARGAINING IN 1984

CONTRACTS that cover more than 40% of the 7.9 million workers under major collective bargaining agreements will expire in the year ahead. Despite this activity, however, 1984 is unlikely to bring a sharp escalation in wage-settlement patterns. That is partly because of the timing of the three-year collective bargaining cycle and partly because of a continuing high level of unemployment and intense competitive pressures at home and abroad.

Changed climate

There was a sharp break between 1981 and 1982 in collective bargaining settlements. For example, the average annual increase in compensation plunged from 8.3% for contracts negotiated in 1981 to less than 3% in 1982 and has held at about that level in 1983 (accompanying chart).*

Behind the deceleration were actual wage-rate declines in a number of contracts and only very modest increases in others. In addition, several important contracts (aerospace, airlines, and bus transportation) specified lower starting salaries for newly hired workers—a trend that will tend to hold down average wage-rate increases in 1984. Unit labor costs were further contained by an easing of union work rules, permitting, for example, workers to take on more than one task.

Many of the unions scheduled to renegotiate contracts this year have yet to feel these trends; they last negotiated at the peak of the cycle in 1981 and received hefty pay increases. But in 1984 such industries as railroads, shipping, and coal mining will have to face up to the wage deceleration of the past two years and the changed climate for collective bargaining. While there may be fewer outright wage cuts than during the past two years, the pattern of relatively modest wage increases and an easing in work rules should continue. Additionally, there is likely to be continued pressure for lower wage rates for "new hires."

Bargaining in the auto industry could prove more spirited than in other industries. Agreements at General Motors and Ford were negotiated in early 1982 and were some of the first contracts to reflect the slowing in wage gains. The union may try to reverse what it perceives as "give ups" and demand "get backs." The experience at Chrysler, where the union demanded and won very large wage increases (25% over three years) to reverse earlier declines, could be a precedent for such demands.

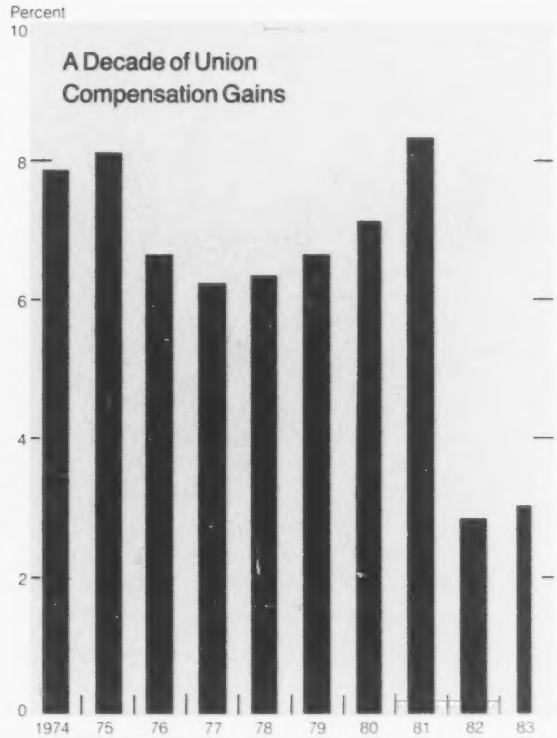
Problems in 1985?

Stiff bargaining in autos in the fall may be the precursor of tougher negotiations in 1985 and beyond.

*These figures do not include possible increases under cost-of-living clauses.

Contracts Expiring in 1984

	Industry	*Workers covered*
January	Petroleum refining	50,000
Various	Construction	1,000,000
June	Maritime	50,000
June	Railroads	300,000
Various	Food stores	300,000
July	Post office	600,000
September	Automobile	600,000
September	Bituminous coal	160,000



Note: Figures cover annual average changes in wages and benefits over the life of contracts that cover 5,000 or more workers. Figures do not include increases under cost of living clauses. Data for 1983 are for nine months.

Climbing corporate profits and a rise in the inflation rate will be cited by union bargainers as justification for higher wages and fringe benefits. Arguing against large increases, however, is the fact that the competitive pressures that played a key role in the changed settlement pattern of the past two years are still likely to be present. In particular, deregulation and new nonunion entrants will continue to provide stiff competition to established firms.

All in all, while 1984 seems likely to produce moderate wage gains and relative labor tranquillity, negotiations in 1985 and 1986 are likely to be more difficult, with an increased probability of labor unrest.

dropped almost four times more rapidly than in the earlier period.

One reason for the slowing in the growth of the labor force is the deceleration in the rate of increase of the working age population. After many years of rapid expansion, reflecting the post-World War II baby boom, the growth of the population age 16 and over slowed (table on page 6). Still, the reduced rate of population growth accounts for less than half of the deceleration in labor-force growth.

The more important, and surprising, reason for the slowing is a flattening in labor-force participation rates. During the 1970s women entered the labor force in increasing numbers, more than offsetting the slight downward trend in the participation rate of men. Higher overall participation rates during this period added a full percentage point to the rate of growth of the labor force. In the past year, the picture has changed. The rate of increase in the participation rate of women came to a virtual halt.

Obviously, employment growth depends critically on the pace of the economy. The Morgan Bank forecast (GNP growth of around 5% in 1984) implies that employment growth will slow somewhat, even though it will remain relatively

Changing Demographics

(Percent change at annual rate)

	1975 to 1979	*Dec. 1982 to Dec. 1983*
Labor force	2.9	1.1
Employment	3.7	4.0
Unemployment rate*	−0.7	−2.5

*Change in percentage points per year.

NOTE: Figures cover the civilian noninstitutional population.

Behind the Slowdown in Labor Force Growth

(Percent change at annual rate)

	1975 to 1979	*Dec. 1982 to Dec. 1983*
Labor force	2.9	1.1
Population*	1.9	1.1
Participation rate	1.0	0.0
Men**	−0.1	−0.4
Women**	2.4	0.4

*Civilian, noninstitutional population of working age.
**Age 20 and older.

rapid—quite possibly in the 2%-to-3% range.

Prospects for labor-force growth are less clear. Growth in the population of working age will remain around 1%. The major question is whether the recent slowing in the rate of increase in the participation rate of women is temporary—possibly related to the recession—or whether it represents an end to a two-decade uptrend.

It is possible that the slowing is primarily a "discouraged worker" phenomenon related to the recession. That seems unlikely, however. Women have been much less affected by the recent recession than have men. The unemployment rate for women has traditionally been approximately two percentage points higher than the rate for men (chart on this page). But in the past two years the rate for women has fallen below that for men.

One reason for this is that industries that have been especially hard hit by the recession (for example, steel, autos, and construction) have relatively few female employees. In addition, the slowdown in the growth rate of the female labor force has probably reduced competition for the types of jobs that are typically held by women.

What happens to participation rates will be a significant factor in determining the unemployment rate in the year ahead. If participation rates remain flat (as they have in the past year) and employment grows 3%, then the unemployment rate would drop below 7% at the end of this year. What seems more likely is that the labor-force participation rate will resume its growth in 1984. But even if higher participation rates added 0.5 percentage points to labor-force growth, the unemployment rate should decline, even if not as spectacularly as in the past year.

The Morgan forecast is for an unemployment rate of 7½% a year from now. Though still some distance from "full employment" (considered by most economists to represent a jobless rate of about 6%), the year ahead should bring added good news on unemployment.

Credit Markets in 1984

DESPITE a slowing in the pace of economic expansion this year, demand for credit, paced by massive Treasury needs and enlarged demands from business and consumers, will grow a bit faster than it did in 1983.

Total outstanding debt in the key nonfinancial sector (all domestic borrowers except banks and other financial institutions) will grow 10.6%, or $552 billion, this year (table on page 8).

Financial markets are likely to take such a rise in stride. But accelerating debt usage could produce some concern on the part of Federal Reserve money managers as 1984 progresses. Although the Fed does not formally target credit growth, it does have a "monitoring range" for growth in nonfinancial debt—set at 8½% to 11½% for 1983.

Last summer, Chairman Volcker announced the Fed's intent to lower that range in 1984 by half a point. Credit demands in prospect this year, thus, appear likely to crowd the top edge of the Fed's credit aggregate growth range. If borrowing does, in fact, turn out that way, the Fed may decide to keep a fairly firm grip on monetary policy—though with inflation fairly well contained and with concerns about developing nations' debt difficulties, no major stiffening seems likely. Against that backdrop, interest rates are expected to move narrowly throughout the year.

A sector-by-sector analysis of The Morgan Bank's credit projections, together with an appraisal of sources of funds:

Federal borrowing. Despite a strong economic recovery in 1983, tax reductions cut revenues and forced the Treasury to tap credit markets for an estimated $185 billion last year—nearly 15% more than in 1982. Indeed, Treasury borrowing would have been even larger had not the Administration made efforts to delay spending at the end of fiscal 1983.

The year ahead promises even larger federal borrowing. Expenditures delayed last year will show up in 1984, boosted by outlays for military hardware just now coming on stream. And, although corporate tax payments this year should surge in response to last year's rising profits, the increase will be muted by a tax law change—effective in 1983—that requires corporations to keep tax payments more current with earnings. Finally, most of the deficit-narrowing impetus from such cyclically sensitive items as transfer payments and personal income taxes (especially given last year's final installment of the personal tax cut) seems largely spent now that the economy is decelerating. The net result is that federal borrowing will likely rise another 5% or so, approaching an average of $50 billion a quarter. Such borrowings would be the highest in history.

Tax-exempt financing. Tax-exempt net borrowing in 1983—estimated at $48.3 billion—fell $2 billion short of 1982's record. But tax-exempt net borrowing includes net issuance of industrial revenue bonds (tax-exempt obligations issued on behalf of eligible corporations), which declined an estimated $5 billion from 1982. Net of those bonds, outstanding obligations of state and local governments rose $38.3 billion, eclipsing 1982's record by nearly $3 billion.

Neither state and local nor other tax-exempt borrowing is likely to set new records in 1984, however. Key reasons: Issuance in 1983 was accelerated beyond actual needs to beat a requirement that tax-exempt bonds be registered in the name of the owner (rather than in bearer form); some net issuance represented "advance

The Demand for Credit

(Billions of dollars)

	1979	*1980*	*1981*	*1982*	*1983**	*1984**	*Outstanding at year-end 1983**
Federal government issues	38.8	79.8	87.8	162.1	186.0	195.0	1173.7
Federal agency issues**	−1.3	−0.5	−0.3	−0.8	0.0	−0.1	3.4
Tax-exempt issues	30.3	30.3	21.9	50.5	48.3	42.0	472.6
Mortgages	163.4	135.0	114.4	82.9	168.2	186.0	1817.1
Corporate bonds and notes	17.3	26.6	22.1	18.8	15.0	12.0	421.0
Other business borrowing (nonfarm)	71.2	36.0	78.6	54.7	23.0	55.0	629.0
Consumer credit	45.4	4.9	24.1	18.3	42.3	45.0	473.0
All other credit	20.8	31.1	28.7	8.6	11.1	17.0	214.2
Total credit demand by domestic nonfinancial sectors	**386.0**	**343.2**	**377.2**	**395.3**	**493.9**	**552.0**	**5204.0**
Funds raised by financial sectors	82.5	63.3	85.4	69.3	77.7	86.8	764.5
Funds raised by foreigners	20.2	27.2	27.2	15.7	15.3	19.0	241.7
Total credit demand	488.7	433.7	489.8	480.3	586.9	657.8	6210.2

*Estimated. Due to rounding, components may not add to totals.
**Budget agency issues and loan participations.

refunding" of higher-cost debt; new federal restrictions on some issues will damp 1984 volume;* and a brightening fiscal picture for states and municipalities will moderate their 1984 credit needs.**

Even so, tax-exempt borrowing will remain high by historical standards. States and localities face pressing infrastructure and other needs, and the expiration of some tax increases that last year helped turn deficits to surpluses will require borrowing to finance many new projects. All in all, total net tax-exempt issuance of $42 billion—corresponding to 8.9% growth in outstanding tax-exempt debt—seems likely. In turn, the $6 billion or so decline in borrowing compared with 1983 should contribute to lower yields on tax-exempt obligations in relation to those on taxable securities.

Business financing. Nonfinancial corporations' external funding needs plunged in 1983 as the recovery and business tax cuts generated a rising tide of liquidity. Cash flow (retained earnings plus depreciation allowances) actually exceeded outlays on fixed investment and inventories by $9.3 billion last year. This comfortable cash situation reflected, in addition to the tax cuts, the biggest first-year profit surge of any postwar recovery and a massive liquidation

*One legislative proposal pending before Congress would limit the volume of "private purpose" tax-exempt issuance in each state to $150 per capita, retroactive to January 1, 1984. The uncertain status of this legislation prompted a rush to issue before year-end, even by states that had not reached this limit. In addition, statutory authority for mortgage subsidy bonds (to finance first-time, single-family home purchases) expired December 31, 1983.

**"Brightening Prospects for States and Localities," *The Morgan Guaranty Survey*, October 1983.

Sources of Funds

(Billions of dollars)

	1979	*1980*	*1981*	*1982*	*1983**	*1984**
Commercial banks	123.1	101.1	103.6	108.5	131.1	146.9
Savings institutions	56.7	54.9	27.2	30.6	113.2	125.1
Life insurance and pension funds	53.0	64.5	69.9	87.3	98.1	91.4
Money market mutual funds	19.8	14.8	62.5	21.4	−20.8	13.3
Other financial institutions	42.1	27.0	42.1	23.4	32.5	58.4
Nonfinancial corporations	5.7	−4.2	2.7	13.7	21.9	21.1
Governments, including Federal Reserve	48.2	47.3	41.2	53.3	70.0	54.1
Federally sponsored agencies and mortgage pools	53.0	45.6	48.2	65.3	70.8	57.5
Foreign investors	−4.6	23.2	16.0	17.6	18.3	25.8
Individuals and other	91.7	59.5	76.5	59.2	52.0	64.2
Total credit supply	488.7	433.7	489.8	480.3	586.9	657.8

*Estimated. Due to rounding, components may not add totals.

of inventories during the first half of the year.

More recently, however, a positive gap has reappeared, with the result that short-term credit demands have picked up noticeably. That trend is expected to continue in 1984. Corporate external financing needs should rise some $23 billion between the fourth quarter of 1983 and the fourth quarter of 1984 as profit growth slows and investment accelerates.

Following last year's pattern, the bulk of long-term financing will be accomplished in equity markets with outstanding medium- and long-term bonds rising only $12 billion—less than 3%. Corporations are expected to satisfy their remaining debt needs—estimated at $55 billion—through short-term instruments: bank loans, commercial paper, loans from finance companies, and bankers' acceptances.

Resurgent borrowing concentrated in short-term markets will interrupt the balance sheet repair that began in mid-1982, as ratios of short-term to total debt and debt to equity begin to creep up. But corporate treasurers and financial institutions, scarred by four years of slow growth and high and volatile interest rates, have recently concocted new treatments for easing balance sheet maladies. These debt-management techniques include interest rate swaps (which enable issuers of floating-rate debt to convert it to a fixed-rate liability), swaps of debt for equity, and more recently "defeasance" of debt (box on page 10). None of these remedies can immunize corporations to a dramatic rise in rates. But they do give corporate treasurers more flexibility to react quickly to financial developments.

Mortgages. Lower interest rates pumped new life into the mortgage market last year. Propelled by a revival of home buying and an influx of funds into mortgage-lending institutions, net mortgage debt formation soared in 1983 to a record $168.2 billion.

CREDIT FLOWS AND "DEFEASANCE"

MORE and more corporations are likely to "defease" debt in 1984, thanks to recent rulings by the Financial Accounting Standards Board (FASB) and the Securities Exchange Commission.* The growing popularity of defeasance could complicate the analysis of credit flows in 1984.

Defeasance allows a business firm to eliminate debt from its balance sheet by purchasing U.S. government securities and placing them in an irrevocable trust. The cash flow from the government securities must be large enough to cover interest and repayment of principal on the debt to be defeased. The debt remains an outstanding liability of the issuing company. But with the debt thus secured, the corporation is allowed to remove the obligation from its balance sheet and to recognize any gains or losses that may have occurred in the process.

Defeasance is an attractive device for a corporation that wishes to retire noncallable securities before they mature or callable, low-coupon securities that are selling below their call prices. When low-coupon issues selling at a discount are defeased, the corporation records a profit on the transaction because the cost of the government securities is less than the book value of that debt. There is no immediate tax liability, however, because the Internal Revenue Service does not consider the debt extinguished until the corporate securities mature. The effect is to provide an immediate lift for the company's earnings.

Defeasance can alter several key barometers of corporate balance-sheet health. If the corporation uses cash to buy the government securities, the ratio of debt to equity will drop as corporate debt is extinguished; the "current" ratio—current assets relative to current liabilities—also will decline. If the corporation instead borrows money to finance the transaction, both the current ratio and the ratio of long- to short-term debt will fall.

The overall impact of defeasance on credit markets is difficult to assess because defeasance is a purely financial transaction that reshuffles financial assets and liabilities. Its impact on credit flows depends upon whether the government securities are purchased with cash or by borrowing. For example, when firms borrow to purchase government securities, both the supply and demand for credit increases as the borrowing leads directly to an increase in corporate purchases of government securities.

Over all, the expected growth of defeasance activity suggests that the government securities market should be more buoyant than it otherwise would be (at the expense of nongovernment issues). Meanwhile, corporate income statements should be enhanced, while corporate liquidity will be reduced.

*This innovative financing technique was developed by The Morgan Bank in 1977. The FASB formally approved the technique last month.

This year promises to set another record for mortgage lending. Even if construction of new housing units stays at about its current 1¾ million unit level—as seems likely—moderately rising home prices and a further pickup in turnover rates for existing homes should make for a higher financing requirement. In addition, the acceleration in commercial mortgage activity begun in the third quarter of last year is likely to continue, as business investment in structures remains on the rebound. Against that background, a 1984 pickup in mortgage lending seems virtually assured. An overall total of $186 billion—a growth rate in outstandings of about 10%—is the most likely outcome.

Consumer credit. A dramatic increase in consumer credit financed much of the stronger-than-expected rise in consumption in 1983.

Taken together, installment and noninstallment credit jumped more than $42.3 billion, or nearly 10%.

Last year's borrowing and spending spree has kept the saving rate—as measured in the national income accounts—well below its 6% historical norm. This might suggest to some that consumers will soon have to rein in expenditures to keep them in line with more moderate income growth. But households can take on substantially more debt before becoming burdened by debt service. In particular, the increase in net worth over the past 18 months was so large that saving as measured by this increase actually rose relative to income. Moreover, growth rates in outstanding consumer debt have been almost matched by those of after-tax personal income. As a result, the ratio of consumer debt to personal income stands at 19.4%—well below its 1979 high of 22%. And despite rising debt, household interest payments should actually decline in relation to disposable income, as high-rate loans taken on earlier mature over the next couple of years.

In that environment, The Morgan Bank expects consumer spending to grow a little faster than disposable income during 1984. Households will continue to finance purchases—particularly of durables—through additional borrowing estimated at $45 billion.

Other credit. As the economic recovery enters its second year, credit demands by farmers and small business proprietors (included in the "all other" category in the table on page 8) should continue to rebound from 1982 lows.

That sums up demand prospects for components of the Fed's credit aggregate. But funds raised by financial institutions and foreigners are also important, inasmuch as they help satisfy nonfinancial domestic credit demands. Funds raised by financial institutions in 1983 were concentrated largely in issues of mortgage-backed and mortgage pass-through securities issued by mortgage "pools." This year, depository institutions seem likely to keep the increasingly popular variable rate mortgages on their books instead of selling them to pools as they did last year with fixed-rate mortgages. That will diminish the share of mortgages purchased by pools in 1984, and thus restrain the pools' growth. But a rising demand for loans at banks and thrifts will boost the total of financial-sector fund raising to an estimated $86.8 billion, pushing their outstanding debt up 11.4%—about the same as in 1983. Borrowing by foreigners in U.S. markets, meanwhile, is expected to rise marginally, in line with the moderate global recovery.

Sources of funds

Where will the money come from to meet these credit needs? The table on page 9 presents The Morgan Bank's estimates of the sources of funds in prospect for 1984.

Regulatory changes affecting institutional deposit gathering will exert an important influence on money flows. Thrift institutions can now bid more effectively for funds and seem likely to continue steering credit to mortgage borrowers, at least so long as their success with adjustable rate mortgages continues. Even if it does not, federally sponsored agencies will be there to continue channeling funds to home builders and buyers from investors not traditionally in the mortgage markets—either by creating new mortgage pools or via direct acquisitions.

Changing patterns of household saving will

also affect the sources of funds. Continued growth in individual retirement accounts and in "cafeteria-style" benefits packages may enable employers to negotiate smaller pension benefits. In addition, a shift to "defined-contribution" plans (as opposed to fixed-benefit coverage) seems likely to reduce the growth in pension funding. Moreover, private pension fund coffers are already bulging in relation to liabilities. As a result, corporate pension contributions could decline, reducing the volume of funds supplied by pension funds. Life insurance companies, meanwhile, will likely supply fewer funds, partly as a result of lower annuity sales which will reduce their new investable assets. In contrast, money market mutual funds—the big loser in last year's household deposit tug-of-war—have since stanched the outflow.

Widening current account deficits will be financed in part by stepped-up U.S. credit-market borrowing abroad.* Changes in U.S.-foreign interest-rate differentials—and in developments that may affect the view of the United States as a "safe haven" for investment—will influence both the strength of the dollar and the magnitude of borrowing from abroad. If, as seems likely, the dollar remains relatively strong, private foreign investors will play a stepped-up role in U.S. credit markets. And if the dollar weakens significantly, foreign central banks may step in to intervene in foreign exchange markets. That would accelerate purchases of U.S. credit-market instruments.

Other shifts in funds flows may make it harder for the federal government to finance its huge deficit. Two key sectors will be buying less Treasury debt in 1984 than they did in 1983. State and local governments, which supplied more than $23 billion to the Treasury last year as their own borrowings ran ahead of actual cash needs, will sharply curtail that financial intermediation. And commercial banks (which financed one-fourth of the federal deficit in 1983) will shift their attention to rising business, consumer, and mortgage credit demands.

The year ahead, unlike 1983, will see federal and business demands for credit rising together, while mortgage and consumer credit will remain buoyant. Although no credit surge is in prospect, the rise should be of sufficient size and strength to convince the Fed to keep the policy reins reasonably snug.

*These foreign credit flows exclude other transactions that help to finance the U.S. current-account deficit. Examples: net direct investment in the U.S.; net purchases of equities; and increases in U.S. bank and nonbank liabilities to foreigners.

Risk-Related Premiums for Deposit Insurance

THE rise in bank failures during the past two years—from an average of six a year between 1946 and 1981 to 42 in 1982 and 48 last year—has caused concern about one aspect of federal deposit insurance. Congress and regulators are worried that the flat-rate premium that depository institutions pay for insurance provokes some to take excessive risks while penalizing institutions that minimize risk-taking.

Such concerns are reflected in a recommendation made in December by the Task Group on Regulation of Financial Services, which is headed by Vice President Bush and which includes the heads of the financial regulatory agencies. It urged the development of a variable-rate premium schedule for deposit insurance. Earlier, the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank

Board (FHLBB)—the manager of the Federal Savings and Loan Insurance Corporation (FSLIC)—had advocated development of a risk-related premium structure.

Under the current deposit insurance system, a depository institution pays a flat-rate premium assessed against total deposits to insure the accounts of each depositor up to $100,000.* Because the premium rate is constant (and is assessed against total deposits rather than only insured deposits), the charge is unrelated to the potential for failure and the increased chances of losses that may have to be borne by the deposit insurance funds.

The FDIC and FHLBB have noted that this lack of linkage between the premium rate and risk has encouraged some banks and thrifts to take excessive risks.** The agencies have recognized that banks and S&Ls have incentives to try to obtain greater returns (by the use of increased leverage, by investing in more risky assets, or by mismatching the maturity distribution of assets and liabilities) because they do not have to pay a premium equal to the expected value of loss to the insurance fund. Following such a strategy, a depository institution can increase its expected rate of return by shifting a portion of the increased risk to the insurance fund. Any losses greater than the capital at risk are borne by the insurance fund and uninsured depositors.

The combination of deregulated interest rates and insurance enables an institution to attract deposits regardless of the likelihood of its failure. Insured depositors are confident that the government will protect their money even if the institution goes under. Moreover, the flat-rate premium assessment means that the cost of funds does not necessarily have to rise as the risk of failure climbs and the expected cost to the insurance fund increases.*

The problem of increased risk-taking is most apparent in the reliance of some financially shaky depository institutions on money brokers as a source of funds. An institution can obtain an almost limitless supply of funds through money brokers regardless of the institution's financial condition. Even though the money brokers are not to blame, their activities are being increasingly linked to bank and S&L failures (box on page 14).

Possible remedies

Regulators and academicians have considered a number of insurance reforms aimed at constraining depository institutions from taking excessive risks. Under one set of proposals, market discipline would be imposed by modifying deposit insurance to incorporate private insurance or coinsurance. For example, federal deposit insurance coverage might be lowered to $10,000 per account with depository institutions left free to purchase additional insurance coverage from private firms at their option. Or, following the British deposit insurance system, deposits could be only partially insured—losses would be allocated between the appropriate insurance agency and the depositor in a 75/25 split. Private insurers would presumably take

*The FDIC, the FSLIC, and the National Credit Union Share Insurance Fund (NCUSIF) all assess a regular premium equal to 1/12 of 1% of total deposits. The FDIC typically refunds a portion of that assessment, depending upon its losses and expenses, so that the cost for banks is usually somewhat smaller. In 1982, the NCUSIF assessed an additional special premium equal to 1/18 of 1% of total deposits.

**In insurance parlance, this is a problem of moral hazard. The insurance encourages risk-taking and increases the likelihood of loss.

*Of course, the existence of deposit insurance does not enable institutions to take excessive risks without consequence. Troubled institutions often will find sources of funds limited as large depositors shift their funds to less risky institutions.

MONEY BROKERS UNDER FIRE

THE FDIC and FHLBB are concerned that many of the banks and S&Ls that have failed recently have relied heavily on brokered deposits for funds. For example, the latest available data show that 26 of the 35 banks that failed during the first 10 months of 1983 relied on brokered deposits. Brokered deposits accounted for 16% of the total deposits of the 72 banks that failed between February 1982 and mid-October 1983.

In response, the FDIC and FHLBB are considering reforms that would increase reporting requirements of banks that rely on brokered deposits and slash the effective level of insurance coverage on such funds.

The two agencies are concerned that money brokers enable depositors to circumvent limits on insurance coverage and allow troubled institutions to continue to attract funds because depositors are not at risk.

Brokers enable depositors with more than $100,000—the FDIC and FSLIC limit on insured deposits at a single institution for each depositor—to obtain deposit insurance on their investment at little cost. Brokers accomplish this by breaking the investments of each client into $100,000 pieces so that a client has no more than that amount on deposit at any one institution. Because the insurance limit is placed on the owner of the deposit rather than the agent that places it, brokers can deposit millions of dollars made up of $100,000 portions with a single depository institution and still obtain deposit insurance on the entire sum. It is this capability that disturbs regulators.

Only a symptom

The activities of money brokers are only a symptom of the underlying problem—the encouragement of risk-taking provoked by the current system of deposit insurance. Even if brokered deposits were banned altogether, depository institutions could continue to obtain funds by other means, such as more widespread advertising. In fact, in the absence of money brokers, the establishment of a national newsletter to provide information to depositors on where they could obtain the highest rates would be a likely development. Depositors could then transfer funds in $100,000 increments to different depository institutions and continue to obtain federal deposit insurance for all these funds.

risk into account in their premium assessments so that there would be several different premium rates based on the risk class to which the depository institution had been assigned.

Under a second set of proposals, the current system would be retained, but the current flat-rate premium schedule would be replaced with a schedule in which the premium rate rose as the risk level increased.

Although both approaches would go a long way toward imposing market discipline, each has shortcomings. Any scheme that utilizes private insurance or coinsurance might not adequately protect the integrity of the payments system. In the case of private insurance, confidence in the banking system could weaken if depositors believed that the private insurance companies might fail. Under a system of coinsurance, widespread withdrawals could occur if depositors who would still have some funds at risk believed failure was a possibility. In addition, a private insurance system might not be viable because of adverse selection—the problem, which plagues virtually all types of insurance, of poor risks being the ones most likely to purchase insurance because they get the best

bargains. Because the institutions most interested in purchasing deposit insurance at any given premium rate would tend to be those most likely to fail, insurance companies might not be able to construct a premium schedule that allowed profitable operation.

The risk-related premium schedule scheme suffers from two flaws. First, it would be difficult, in practice, to determine an appropriate risk premium structure. Not only is the riskiness of a given portfolio difficult to evaluate, it is not apparent how steep a premium schedule would be needed to constrain the risk-taking that the insurance agencies deem unacceptable. Second, any premium schedule that included higher rates for increased risk-taking could prove to be destabilizing in practice. For example, sharply higher premium rates could encourage even greater risk-taking as institutions sought even higher yields to cover the cost of the increased deposit insurance premiums. In addition, disclosure that an institution had to pay a higher premium rate could cause depositors to withdraw uninsured funds or to demand higher interest rates. Moreover, such a premium schedule would punish all institutions that suffered a deterioration in the quality of their portfolios, regardless of the reason for the decline. In practice, the premium schedule might not always discipline the risk-taking behavior that the FDIC and FHLBB wished to discourage.

Better than the current system

Despite these shortcomings, either a private-federal insurance partnership or federal deposit insurance with risk-related premiums assessed against insured deposits would represent an improvement over the current system.

The drawbacks could be minimized by introducing some additional features. For example, if the risk of failure of private insurers were deemed to be a serious problem, the federal government could reinsure some portion of the insurance written by the private sector. Or, under a risk-related premium schedule, premiums could be set on the basis of relative performance, so that when economic downturns occurred the overall level of premiums that were assessed would not increase above some threshold. With this modification, a risk-related scheme would not increase the overall stress on the financial system during recessions.

While determining an appropriate premium schedule would not be easy, it would not be impossible. Just as drivers pay premiums for car insurance based on such characteristics as sex, age, or distance to work, so could depository institutions be assessed premiums based upon certain characteristics (such as capital adequacy, asset diversification and quality, and interest-rate risk) that are related to the likelihood of failure. As experience was gained with a risk-related premium scheme, the system could be refined.

Movement towards risk-related premiums would be a step in the right direction. Financial markets would become more efficient because the subsidy to risk-taking depository institutions would be reduced. In addition, a depository institution would begin paying for deposit insurance on a basis of how much risk of loss the institution imposed upon the deposit insurance fund. And institutions that minimized risk-taking would no longer be penalized by the fees they were assessed for insurance coverage.

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